No. 22802

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE SIXTY TRUST,

Appellant,

vs.

WM. B. ENRIGHT, Trustee, etc.,

Appellee.

BRIEF FOR THE APPELLEE, WILLIAM B. ENRIGHT, TRUSTEE.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

List of Abbreviations.

P.	Petition
A.	Answer to Petition for Reorganization
R.	Transcript of Record
AR.	Additional Transcript of Record
V. I	Volume I of Transcript of Proceedings held on June 28, 1967
V. II	Volume II of Transcript of Proceedings held on June 30, 1967
V. III	Volume III of Transcript of Proceedings held on June 30, 1967
Tr.	Transcript of Proceedings held on September 21, 1967
Ex.	Exhibits to hearing held on June 28, 1967 and June 30, 1967

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I.

Statement of Jurisdiction.

The Debtor filed a voluntary petition for the reorganization of a corporation, pursuant to the provisions of Chapter X of the Bankruptcy Act (Title 11 U.S.C. Sections 501-676). The jurisdiction of the United States District Court in this matter is predicated upon Title 11 U.S.C. Sections 46, 502, 511, and 528.

The jurisdiction of the Court of Appeals to hear this matter on appeal is predicated upon Title 11 U.S.C. Sections 47, 48, and 521.

II.
Statement of the Case.

University City, a California corporation, filed its petition for the reorganization of a corporation on April 25, 1967 [R. 2]. The District Court, upon consideration of the petition and the allegations contained therein, issued its initial order approving the petition and appointing Trustee, order of reference and restraining order and amendment thereto [R. 23-29]. Appellant, The Sixty Trust, a secured creditor of the Debtor, filed its answer to the petition for reorganization [R. 37], pursuant to the provisions of Section 137 of the Bankruptcy Act (Title 11 U.S.C. Section 537), seeking dismissal of the Chapter X petition pursuant to the provisions of Section 144 of Chapter X of the Bankruptcy Act (Title 11 U.S.C. Section 544), on the ground that the proceedings were not filed in good faith within the meaning of Section 146 of Chapter X of the Bankruptcy Act (Title 11 U.S.C. Section 546).

The answer of appellant denied certain allegations of the petition, and put the Debtor to its proof. The major thrust of appellant in the proceedings below as set forth in the second defense of the answer of appellant [A. 3, R. 37] was that the petition was not filed in good faith as defined in Section 146(3) of the Bankruptcy Act, in that it is unreasonable to expect that a plan of reorganization can be effected by the petitioner for certain reasons set forth in the answer. Appellant also set forth as a special defense to the proceeding, that a portion of the Debtor's real property had been transferred to it shortly before the Chapter X proceedings by certain officers, shareholders and directors for the purpose of bringing said property with-

in the injunctive power of the corporate reorganization court.

There was a two-day hearing before the Referee and Special Master, pursuant to Section 144 of the Bankruptcy Act (Title 11 U.S.C. Section 544), following which the Referee and Special Master, on August 16, 1967, filed her report and proposed findings of fact and conclusions of law [R. 76-81]. Appellant filed its objections to the report, findings and conclusions of the Referee and Special Master [R. 84-96], and oral argument was presented to the District Judge. The District Court, on October 3, 1967, issued its order confirming the Referee and Special Master's report, findings and conclusions of law, and approving petition pursuant to Section 144 [R. 102]. The report of the Referee and Special Master, which was confirmed and approved by the District Judge, and her findings of fact and conclusions of law which were adopted as the findings of fact and conclusions of law of the District Court, are enlightening and an appropriate starting point for consideration of this appeal.

The essential jurisdictional requirements of Chapter X were found to exist. It was found in Finding of Fact 6 that the principal assets of the Debtor consist of approximately 2400 acres of real property situated in the northern part of the city of San Diego, consisting of approximately 1500 acres known as University City, with a fair market value of approximately $15 Million to $17 Million and approximately 900 acres known as Sorrento Properties, with a fair market value of $5 Million. The total value of the real property was, therefore, found to be between $20 Million to $22 Million. The indebtedness owing to appellant was found

to be approximately $10,390,000.00 as of April 28, 1967. In view of this substantial equity over and above the lien of appellant herein of approximately $10 Million, the Court found, in Finding of Fact 8, that it was reasonable to expect that a plan of reorganization could be effected. The Court further found in Finding of Fact 10 that the Debtor's petition was filed in good faith as required by Section 144 of the Act. The Referee and Special Master reported that the property known as the Sorrento Properties, was subject to the same indebtedness as the Debtor owed to appellant at the time it was transferred to the Debtor, and that because of its location near the other properties of the Debtor, it is reasonable to develop it as one unit. The Referee and Special Master upon consideration of the evidence, reported that the transfer of the property to the Debtor was in the interest of the Debtor, because the Debtor acceded to a large equity in said property, and furthermore that the transfer did not result in a fraud upon any creditor. The court concluded, in Conclusion 5, that the petition was filed in good faith and should be approved, and in Conclusion 6, that the Debtor is entitled to relief under Chapter X of the Bankruptcy Act.

The thrust of the position of appellant in the Court below was that it was unreasonable to expect that a plan of reorganization could be effected in the fact of the opposition of The Sixty Trust. Therefore, the proceedings should be dismissed. This is shown in the objections to the report of the Special Master, findings

of fact and conclusions of law upon contested petition filed under Chapter X [R. 84] page 11, lines 25 through 27, wherein it was stated as follows:

> "The only issue before the Court is whether it is reasonable that a plan of reorganization can be effected in the face of the announced opposition of The Sixty Trust, . . .".

It is apparent that the appellant has now abandoned its attack on the essential allegations of the petition; have accepted the essential findings that there is a substantial equity in the real property, and that it is reasonable to expect that a plan of reorganization can be effected, and have, instead, chosen to rely on the fact that out of 2400 acres belonging to the Debtor, some 900 acres thereof were transferred to the Debtor shortly before the filing of these proceedings, in order to bring said property within the jurisdiction of the reorganization court, as the sole basis to force a dismissal of the entire Chapter X proceedings.

III.

Issue on Appeal.

Assuming all of the findings of fact of the District Court are correct, and assuming all of the conclusions of law of the District Court are correct, must the fact that, shortly prior to the filing of the Chapter X proceedings two of the principals of University City transferred 900 out of the 2400 acres to University City, force the Appellate Court to direct a dismissal of the corporate reorganization proceedings under the circumstances of this case.

IV.

The Evidence and the Record.

Appellant, in its brief, has examined one sentence in three volumes of transcript, and has ignored all the rest. Appellant has cited Mr. Carlos Tavares, a candid, honest and highly respected man, as testifying,

> "Well, we deeded it to University City because we wanted to protect our interest in the land that was being foreclosed by The Sixty Trust" [V. I, 31:20-24].

Now, let us look at the rest of the record.

Sorrento Properties, Inc. was a corporation that was dissolved in December, 1966 [V. I, p. 30, line 16]. Just prior to its dissolution, it owned some 900 acres of real property immediately adjacent to the real property owned by University City [V. I, p. 31, line 4]. The original shareholders and principals of both University City and Sorrento Properties, Inc., to wit, Kahn, Tavares, and Lesser, are substantially the same [V. II, p. 55, line 24]. Sorrento Properties, Inc., owned by the same principals as University City, never really functioned, but served only as an appendant to and adjunct of University City. Sorrento never issued any stock [V. II, p. 51, line 10]. It never sold any of its real property during its existence [V. II, p. 49, line 13]. Its Board of Directors never functioned [V. II, p. 55, line 1]. That every dealing Sorrento had were so interrelated with the affairs of University City, as to make their separate existence a fiction. Consider the following evidence. Tavares testified with reference to the affairs of Sorrento Properties [V. II, p. 53, line 13]:

> "Early in 1961, we (Sorrento) had a first loan with Pacific Finance of which totalled almost two

and a half million, and all the money that was received on the two and a half million went to University City."

The supplemental clerk's transcript of record at page 29 shows this promissory note dated July 10, 1961 in the amount of $2,500,000.00 in favor of Pacific Finance Corporation. It was actually executed by both Sorrento Properties, Inc. and University City. This note and the trust deed which covers the property of both corporations were assigned to The Sixty Trust [Supplemental Clerk's Transcript p. 74], and makes up part of the claim of The Sixty Trust and its wholly-owned subsidiary S.D. Land, Inc.

In 1963, University City borrowed an additional $4,250,000.00 from The Sixty Trust, increasing its obligation to The Sixty Trust to $9,250,000.00 [Supplemental Clerk's Transcript, p. 10]. The note was executed only by University City. However, the deed of trust given to secure the note of $9,250,000.00 was executed both by University City and Sorrento Properties, Inc. The property covered in said deed of trust, which stood as security for said note, is the property of both University City and Sorrento Properties, Inc. [Supplemental Clerk's Transcript, p. 35]. Similarly, the succeeding notes to The Sixty Trust in 1964 and February 1, 1965, were executed only by University City. However, the deeds of trust covered the property of both University City and Sorrento Properties, Inc. [Supplemental Clerk's Transcript pp. 17-28, 55-65].

What happened to the money University City borrowed from The Sixty Trust in 1963? Mr. Tavares testified [V. II, p. 39, line 17]:

"When Mr. Kahn in 1963 went to Sixty Trust to get an additional loan of $5 Million, he finally

got $4,250,000, and there was not adequate security of University City, based on their 60% loan or 70% loan, and they required land from Sorrento Properties to be used as collateral."

Of the monies borrowed by University City in 1963, it paid over $657,000.00 thereof to Sorrento Properties, Inc. [V. II, p. 53, line 21]. In other words, in 1961 Sorrento had paid over some two and a half million dollars to University City. In 1963 University City had paid over some $657,000.00 to Sorrento. Mr. Tavares testified in some detail concerning these transfers of money [V. II, p. 53, line 21]:

". . . the only monies that Sorrento Property got in 1963 was the $657,000.00 in cash to pay off some first trust deeds that were 5% trust deeds stating in there, 10% loan from Sixty Trust. Mr. Kahn used Sorrento Properties' cross-collateralized, used it primarily as a vehicle to provide money for University City, and there is no question about that.

"Q. And you disapproved of course?

"A. I didn't say I disapproved; the only way that Sorrento Properties and University City could be one and only, and I would have had no objection.

"Q. They weren't?

"A. They might not have been, because you have two different corporations, BUT ACTUALLY, I THINK THEY WERE." (Emphasis added).

By the time Sorrento Properties, Inc. was dissolved in December of 1966, Tavares had bought out Lesser's interest and the assets of Sorrento Properties, Inc. was to be divided two-thirds to Tavares and one-third to

Kahn [V. I, p. 31, line 7]. This dissolution was entered into for tax purposes [V. II, p. 83, line 17]. Shortly before the filing of the Chapter X proceedings, the 900 acres formerly belonging to Sorrento Properties, Inc. was transferred into the name of University City [V. II, p. 94, line 7].

Immediately before the transfer of the 900 acres from Sorrento to University City, the books of University City showed an account receivable due from Sorrento Properties, Inc. in the amount of $2,661,813.09. This receivable from Sorrento to University City was eliminated upon the transfer of the land [V. I, p. 82, line 11; p. 83, line 18].

In other words, immediately prior to the filing of the Chapter X proceedings, the Debtor was indebted to The Sixty Trust in an amount approximating $10 Million. The principals of University City and Sorrento Properties, Inc. allocated the total amount of those loans and determined that $2,661,813.09 was Sorrento's share. This receivable then represented the allocate share charged to Sorrento of the monies borrowed by University City on the note and trust deeds held by The Sixty Trust [V. II, p. 68, line 14].

So intertwined were the financial affairs of University City and Sorrento Properties, Inc., that merger was discussed between them in 1963 and 1965 [V. III, p. 131, line 17].

Not only were their financial affairs inexorably intertwined, but the properties owned by the two "separate" entities was immediately adjacent to one another and basically part of one development. Sworn statement of Mr. Tavares was quoted by the appellant in its opening brief. Mr. Tavares, however, went on to

explain that statement and the explanation was not quoted by the appellant. We now refer the Honorable Court of Appeals to Mr. Tavares' explanation as to why the 900 acres was put into the reorganization proceedings of University City [V. I, p. 38, line 4]:

> "On that date, Mr. Kahn and myself and the rest of the Directors of University City decided that this was the best course, because there was no other way for us to look at it. There was only one loan that covered the entire indebtedness, and Sorrento Properties was cross-collateralized and we couldn't possibly segregate it.
>
> "Referee Rossi: Was it considered as one deal?
>
> "The Witness: One development."

Further at V. I, page 38, line 21:

> "Q. Tell me who you meant when you indicated it was always considered by all of you as one development?
>
> "A. Mr. Lesser, Mr. Kahn and myself; we have always considered this as one development, because when we agreed to put a loan with Sixty Trust, we gave up some very good valuable piece of property to help University City."

So the logic of the transaction becomes apparent. How can you reorganize a part of a development? If a reorganization was to make sense the entire development had to be reorganized as an entity. This was not a last minute device to hinder, delay or defraud anyone. The parties always considered this to be one development, and the Referee and the District Judge so found. They believed Mr. Tavares when he testified as to the basis of the transfer and that the transfer was not to defraud creditors [V. I, p. 32, line 10; p. 33, line 8].

V.
Argument.

On appeal, it is basically not the duty of the appellee to show that there is evidence in the record to support the findings and conclusions of the District Court. Nevertheless, so convinced is the Trustee, not only that the findings and conclusions of the District Court were not clearly erroneous, but rather, that the facts, the logic and the realities of the situation compelled the decision that was reached by the Referee and Special Master, and by the District Judge.

The appellant has referred this Honorable Court to cases which are not at all applicable to the factual situation of these proceedings. The Sixty Trust is not essentially a creditor of Sorrento Properties, Inc., or of Kahn and Tavares in connection with its claim herein. It is a creditor of University City. How could it be defrauded, or how could any of the creditors of University City be defrauded by the deeding to University City of additional assets? If the insolvency cases cited are a correct statement of the law, and we submit they are not generally accepted as a correct statement of the law, they are still not applicable to the facts of this case. First, The Sixty Trust and the other creditors of University City could not have been hindered, delayed or defrauded by the deeding to University City of additional assets. Second, University City was not an entity created and set up by Kahn and Tavares in order to hinder, delay or defraud its creditors. No such creditors of Kahn or Tavares have come into these proceedings to complain of the transfer. They would appear to be the only such creditors with standing to complain. What we have in this case were obligations against the

land in favor of a creditor of University City, which obligations against the land remained unchanged before and after the deeding. As Judge Carter stated in the hearing below [Tr. p. 4, line 11]:

> "How did deeding it to University City protect their interests?"

At line 14 he stated:

> "It couldn't change the obligations against the property, could it?"

Finally, at page 6, line 17 Judge Carter stated:

> "The Sixty Trust still had the same obligations on the property, secured obligations, it had before, right? Their prejudice, if any, is the delay that might entail from a Chapter X."

It is clear then, that the District Judge, as well as the Referee and Special Master, concluded that this was not a case of fraud and that there was no absence of good faith. Their decision, surely was not "clearly erroneous".

The factual situation of these proceedings shows up the danger of attempting to apply a hard and fast rule of law to every case at hand. The cases cited by appellant stand for the proposition that where an individual debtor transfers his assets to a newly formed, wholly owned corporation, which thereby acquires all of its assets, and thereby assumes all of its obligations, and such newly formed corporation immediately files a voluntary petition for reorganization, a legal fraud has been perpetrated, which would justify the Court, *ipso facto,* in dismissing the reorganization proceedings.

This matter is commented on succinctly in *6 Collier on Bankruptcy*, 14th Edition, page 1028. The author states:

"As to whether this constitutes bad faith, the courts are not in agreement. The Eighth Circuit has declared that such a transaction perpetrates a legal fraud on creditors and that it is without the intendment of the statute to construe as within the scope a corporation formed to take over the property of an individual debtor for the purpose of using the statute. The Seventh Circuit, however, has taken the position that circumstances may warrant a departure from such a rule. *In Matter of Loeb Apartments, Inc.,* (CCA 7th, 1937) 89 F.2d 461 the court stated:

'No one evidentiary fact can ordinarily be given paramount weight in deciding the question. If it is obvious that if a debtor is attempting unreasonably to defer and harass creditors in their bona fide efforts to realize upon their securities, good faith does not exist. But if it is apparent that the purpose is not to delay or defeat creditors but rather to put an end to long delays, administrative expenses, statutory periods of redemption and unreasonable obstruction by minorities, incident too frequently, we are sorry to observe, to mortgage foreclosure, and to invoke the operation of the act in the spirit indicated by Congress in the legislation, namely, to attempt to effect a speedy efficient reorganization, upon a feasible basis, supported by more than two-thirds of all the creditors, good faith cannot be denied.'

'. . . It is urged that the fact that it seems probable that this corporation was organized for the

> purpose of filing a petition . . . is a bar to a finding of good faith. No court is justified in making this one fact, arbitrarily, the determinative factor of good faith.'
>
> "This seems to be the better view and exemplifies the flexible nature of the concept of good faith in its relation to the particular conditions presented for the judge's scrutiny."

To the same effect see *Krueger v. Knickerbocker Hotel Co.* (CCA 7th, 1936) 81 F. 2d 981.

Your Trustee, therefore, would take the position that even if University City were newly organized on the eve of the filing of the Chapter X proceedings for the sole purpose of filing the Chapter X proceeding, and even if University City had received all of its assets and liabilities from Kahn and Tavares on the eve of filing the Chapter X proceedings, the District Judge would be justified in going into all of the facts surrounding the transfers in determining good faith.

However, this is not the fact in these proceedings. The cases cited and the proposition of law urged by the appellant herein are just not applicable to these proceedings. University City existed and did business, including substantial business with appellant, for years. The proof of claim filed by The Sixty Trust herein contains promissory notes and deeds of trust going back to July 10, 1961. [Supplemental Clerk's Transcript, p. 6]. In addition, the obligations of University City in these proceedings are not the obligations of Kahn and Tavares, but the obligations of University City. In addition, the major portion of the property was not deeded to it by Kahn and Tavares, but was owned

by University City for years. Only 900 out of 2400 acres were deeded.

Finally, appellant has asked this Court, at the very minimum, to exclude, "the transferred property from the reorganization proceeding and the vacating of the restraining order relative to their property" (Appellant's opening brief, p. 7).

Appellant argued this same issue before the Referee and Special Master and before the District Judge. Both concluded that the instant proceeding was a good faith hearing only; that good faith was the only matter before the Court to decide; not whether or not leave should be granted to foreclose on a particular portion of the property of the Debtor. Such an issue as was stated by the Referee and Special Master [V. I, p. 42, line 18]:

> "Well, that would unduly complicate the present proceeding. It seems to me if you want to lift the restraining order, file a petition and bring it on for hearing and put on evidence; that is a separate issue in itself and not properly at issue, I don't believe in the Section 144 answer, but you can bring it on and I will hear it if you want to. I don't want to have it mixed up."

The Trustee urges that the Referee and Special Master and the District Judge were both correct in refusing to be so sidetracked.

The Trustee urges upon this Court a reading of the very recent case of *DeMet v. Harralson* (C.A. 5th, 1968) CCH Bankruptcy Reports, paragraph 62838, p. 72443 at 72445, where in the Court stated:

> "As an appellant tribunal, we must give deference to the finding of the referee who was in

closer proximity to the economic life of the bankrupt, to the parties involved in its birth and demise, and to its transactional history."

Further at page 72445:

"Moreover, application of the clearly erroneous doctrine becomes paramount when, as here, the district court has approved the referee's determination.

Your Trustee respectfully concludes by urging not only that the decision of the District Court and the Referee and Special Master were not clearly erroneous, but rather, that they were eminently correct. The fact that appellant has withdrawn from its attack upon the position that it was unreasonable to expect that a plan of reorganization could be effected, the fact that the appellant has withdrawn from its attack on the elements in the petition essential to support approval of a Chapter X proceeding, the fact that the appellant has instead chosen to rely on one fact alone, namely the transfer of 900 acres shortly before the filing of the proceedings, and the fact that the record and the evidence amply show that this transfer was not fraudulent and that there were good, economic and business reasons for the transfer to take place, and for the 900 acres to be included in the reorganization, all point to the soundness of the decision below. Your Trustee respectfully urges that the decision below be affirmed.

Respectfully submitted,

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